Testimony of James E. Smith
On Behalf of the American Bankers Association
Before the
Subcommittee on Financial Institutions and Consumer Credit
of the
Financial Services Committee
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Mr. Chairman, I am James E. Smith, Chairman and CEO of Citizens Union State Bank and Trust, in Clinton, Missouri, and President-Elect of the American Bankers Association (ABA). I am pleased to be here today on behalf of the ABA. ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks – makes ABA the largest banking trade association in the country.

I would like to thank you, Mr. Chairman, for holding this hearing to examine some key issues related to the Federal Deposit Insurance Corporation (FDIC). Assuring that the FDIC's deposit insurance funds remain strong is of the utmost importance to the banking industry. Over the past decade, commercial banks and savings associations have gone to extraordinary lengths to rebuild the insurance funds, contributing $36.5 billion to ensure that the insurance funds are well capitalized. With the Bank Insurance Fund (BIF) at nearly $31 billion and the Savings Association Insurance Fund (SAIF) at nearly $11 billion at year-end 2000 – ***representing over $41 billion in financial resources*** – it is safe to say that FDIC is extraordinarily healthy.

The outlook is also excellent. There have been few failures, and the interest income earned by BIF and SAIF (nearly $2.5 billion per year) is roughly three times the FDIC's cost of operation. As interest income continues to exceed expenses, the BIF and SAIF are likely to continue to grow further beyond the designated reserve ratio mandated by Congress. Moreover, the banking industry is extremely well capitalized, adequately reserved for potential losses, and profitable.

With the deposit insurance funds so strong, now is an appropriate time to consider how we might improve the overall system. Since testifying last year before this subcommittee, the ABA has held extensive discussions with commercial banks and savings institutions, as well as with Members of Congress and their staffs, and the FDIC in order to facilitate the development of an approach that would both strengthen the system and be acceptable to a broad range of parties. The FDIC in particular, under the leadership of Chairman Tanoue, has done an excellent job developing an approach that addresses many of the key issues. While we do not agree with every detail in the FDIC's report **– *and are particularly concerned about the possibility of increasing premiums* –** we believe that the report can serve as a basis for congressional action.

The ABA has stated for the past year that a bill to strengthen the FDIC is likely to be enacted only if an industry consensus in support of such legislation can be developed. As you will see today, while some differences remain, the positions of the ABA, America's Community Bankers and The Independent Community Bankers of America are very similar. These three associations have agreed that we should discuss the issues together on an ongoing basis and work together with this committee to develop legislation that would have broad support.

I would add that while there is a general belief among most bankers that we should work with Congress to strengthen the FDIC, there is also concern that such legislation could evolve to increase banks' costs or to become a vehicle for extraneous amendments. If that were to be the case, we have no doubt that support would quickly dissipate. Fortunately, we also believe working together, we can see a consensus bill develop that can have broad bipartisan support.

In my testimony today, I would like to make several key points:

- ***Today's System is Strong and Effective, But Some Improvements Could Be Made***. It is the position of the ABA that we have a workable deposit insurance system that has the confidence of depositors and banks. However, there are areas that can be improved. Any reform should strengthen and improve the deposit insurance system, enhance the safety and soundness of the banking system, and improve economic growth.

- ***A Comprehensive Approach Is Required***. Because deposit insurance issues are intrinsically interwoven, any changes must consider the overall system. For example, any consideration of changes to the risk-based authority of FDIC must be paired with a formula for rebating excesses in the insurance fund.

- ***Changes Should Only Be Adopted If They Do Not Create Large Additional Costs To The Industry***. The ABA will work to develop and support a consensus position, but ABA will oppose deposit insurance legislation that imposes significant new insurance costs or contains negative add-on amendments not material to deposit insurance reform.

I would like to discuss these points more fully, and in the process, discuss specific issues.

Today's System is Strong and Effective, But Improvements Could Be Made

For over 65 years, the deposit insurance system has assured depositors that their money is safe in banks. The financial strength of the FDIC funds is buttressed by strong laws and regulations including prompt corrective action, least cost resolution, risk-based capital, risk-based premiums, depositor preference, regular exams and audits, enhanced enforcement powers and civil money penalties. Many of these provisions were added in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and the FDIC Improvement Act of 1991 (FDICIA).[1] Taken together, these provisions should reduce the number of bank failures, lower the costs of those that do fail, and ensure that the FDIC will be able to handle any contingency. Even more important is that the ***banking industry has an unfailing obligation – set in law – to meet the financial needs of the insurance fund***.

Simply put, the system we have today is strong, well capitalized and poised to handle any challenges that it may encounter for decades to come. As with any system, there is room for improvement. We would propose three litmus tests for any reform: (1) it should strengthen and improve the deposit insurance system; (2) enhance the safety and soundness of the banking system; and (3) improve economic growth.

[1] See Apprendix A for details of these significant safeguards under current law that protect the FDIC funds.

A Comprehensive Approach Is Required

Last year in our testimony, we strongly urged that any approach to reforming the FDIC be done in a comprehensive manner. A piecemeal approach would not only leave some important reforms undone, but worse, could lead to unintended problems. Since last year, support for a comprehensive approach has clearly grown. We are pleased that the FDIC's proposal is comprehensive and acknowledges the important interactions between issues. In this section of my testimony, I want to give you ABA's perspective on what constitutes a comprehensive approach. We recognize that no bill is likely to cover in full all of the issues discussed below, but we respectfully suggest that all of them should be on the table for consideration.

Mutual Approach

The ABA believes consideration should be given to the ***concept*** of converting the current insurance program to a mutual approach in which banks are provided with some type of ownership interest. Under such an approach, dividends would be paid based on the ownership interest. These dividends can be used to offset premiums owed by individual institutions and would, under certain circumstances, exceed the premiums due. In addition, the mutual approach will help address the issue of new and fast growing institutions paying no premiums, since such institutions will not have the same dividend stream to offset premiums due. A great deal more work needs to be done to develop a specific proposal. We are pleased to see the outlines of such an approach in the FDIC's proposal.

Deposit Insurance Limit

As ABA stated last year before this subcommittee, the current $100,000 insurance limit – set in 1980 – has lost over half its value when adjusted for inflation. As a consequence, it is more difficult, particularly for smaller institutions, to raise sufficient amounts of funds to meet loan demand in their communities. For many banks, sources of funding is the number one issue. Recent increases in loan-to-deposit ratios demonstrate that many community banks are searching for funds to support loan demand. In discussing this issue, three items deserve consideration: (1) indexing the insurance limit to account for inflation; (2) raising the insurance limit above the current $100,000; and (3) providing additional coverage to IRAs and other retirement accounts held at banks. Let me briefly discuss each in turn.

Indexing: There is general support within the banking industry for permanently indexing the level of deposit insurance coverage. Under an indexing system, the insurance limit would be automatically adjusted from time-to-time, based on changes in an appropriate index. These changes should be in level increments – e.g., five thousand dollars – to avoid consumer confusion. Without indexing, the insurance level constantly falls behind inflation, as Congress cannot be expected to regularly pass increases.

Base for Indexing: There has been a great deal of discussion within the banking industry, as well as in the Congress and the regulatory agencies, about the appropriate year to use as the base for beginning any inflation adjustment. For example, as the FDIC has pointed out, if the base chosen were 1980 (when the limit increased from $40,000 to $100,000), the insurance level would be approximately $200,000 today to account for inflation; if 1974 were chosen (when the limit was increased from $20,000 to $40,000), the new limit would be approximately $140,000.

In discussions with bankers over the last year on this topic, two questions emerged about increasing the coverage level: (1) what are the potential economic costs; and (2) how many new deposits might flow into the banking system? To help answer these questions, ABA hired Professor Mark Flannery of the University of Florida. Dr. Flannery's study was extremely helpful in understanding the potential economic benefits and costs of various increases in the deposit insurance level.

The study concluded – based on research conducted separately with bankers, individuals and small business owners – that doubling coverage could result in net new deposits to the banking industry of between 4 percent and 13 percent of current domestic deposits, with the lower end of the range more likely, in Flannery's opinion. These hypothetical new deposits, plus the added protection that existing deposits (between $100,000 and $200,000) would receive, would lower the BIF-SAIF reserve ratio below the required 1.25 percent. This would eliminate the $3 billion cushion that exists today and would, under current law, require a 3-13 basis point assessment on all domestic deposits to return the ratio to 1.25 percent.[2]

This study – the first attempt to assign real numbers to a complicated and theoretical concept – stimulated considerable discussion in the banking industry. Several points of view emerged: First, there are many bankers who strongly believe an increase to $200,000 is important to improve their access to funding and that the benefit would exceed the potential cost. Second, there are also many bankers who are very concerned about the loss of the current buffer above the 1.25 percent reserve ratio and the potential for premium increases that would accompany a doubling of the insurance limit. Third, there are bankers who expressed concerns about the political acceptability of such an increase.

Taking these points of view into consideration, we believe that it is reasonable to increase the current limit to the maximum possible that can be achieved without incurring significant costs that would outweigh the value of the increase. However, the bottom line is that we need to develop a comprehensive bill that addresses the key issues outlined in this statement and in the FDIC's proposal and that can also be enacted. We do not know where many of you on this subcommittee stand on the issues, nor do we know the Administration's position. We do know this is a controversial issue and therefore want to work with you to see what approach can be developed that can have broad support.

Retirement Savings: The ABA believes Congress should also consider the possibility of a higher level of insurance for long-term savings vehicles, such as IRAs, Keoghs and any future private social security accounts. These are long-term investments that tend to grow considerably over time, frequently exceeding the current $100,000 limit. For example, at an interest rate of 6 percent, even an annual deposit of $2,000 in an IRA would grow with compounding to over $110,000 in 25 years. And because stock market volatility may be particularly worrisome to retirees, the security of insured deposits is very appealing. Moreover, these deposits represent a very important, stable funding source for bank lending.

[2] The full study is available at aba.com.

A differential for retirement savings accounts is not a new concept. In fact, in 1978, Congress passed the Financial Institutions Regulatory and Interest Rate Act that provided IRA and Keogh accounts coverage up to $100,000 – ***two-and-a-half times*** the $40,000 limit that was in place at that time. The Senate Banking Committee Report on the Act justified the differential coverage this way: "The committee believes that an individual should not have to fear for the safety of funds being saved for retirement purposes." Such a concern is as important today as it was then.

Capping the Insurance Fund and Expanding the Rebate Authority

The ABA has long advocated that the insurance fund should be capped and the rebate authority expanded. Not only are the BIF and SAIF currently fully capitalized, they are $3.5 billion over the 1.25 percent designated reserve ratio (DRR) set by Congress following the difficulties in the 1980s. Moreover, with interest income exceeding the FDIC's operating expense by $1.5 billion a year, it is highly likely that the insurance funds will continue to grow. The compounding effect will mean even greater rates of growth in the future. We believe the FDIC's proposal – ***which for the first time acknowledges the importance of rebates as a check on excessive growth of the fund*** – is a tremendous step forward. While in the past we have advocated direct rebates, a dividend approach accomplishes the same purpose and ABA supports that approach.

The funds held in excess of the DRR are not necessary to ensure the soundness of the deposit insurance system. As I mentioned above, the FDIC has the authority to adjust premium levels and has significant regulatory powers over depository institutions to ensure that the FDIC can meet any funding contingency. Even more important, the ***banking industry is legally obligated to meet the financial needs of the insurance fund.*** Simply put, limiting the size of the fund and expanding the rebate or dividend authority will not affect the FDIC's ability to meet any future obligations to insured depositors.[3]

On the other hand, allowing the FDIC to continue to hold excess funds represents a significant loss of lendable funds for banks in the communities they serve. I can tell you as a banker that I certainly can put rebates to good use in my community providing loans and services to

[3] See Appendix A for details of additional FDIC powers and authorities.

my customers. This will have a far greater positive impact on economic conditions in Clinton, Missouri, than if that money sits in the government's coffers in Washington.

As noted above, we believe that viewing the FDIC more as a mutual insurer will naturally lend itself to a rebate system, through the payment of dividends from the fund. While the details of a cap and dividend system need to be worked out, we believe the 1.40 percent cap proposed in H.R. 4082 and S. 2293 (as introduced in the last Congress) is a reasonable point at which to cap the funds.

Premiums From New and Fast Growing Institutions

Most bankers believe there is an inherent unfairness in the current system that allows new and fast growing institutions to pay no premiums, even though their growth materially dilutes the coverage reserve ratio of the insurance funds. These new and fast growing institutions should be required to pay premiums. For many bankers this has become a top priority in FDIC reform. This problem can be addressed through a combination of a dividend/rebate system under the mutual approach and a newly structured risk-based system, such as that proposed by the FDIC.

Municipal Deposits

In a number of states municipal deposits are a significant source of funding, particularly for community banks. However, collateral requirements for municipal deposits often entail a costly administrative burden and have a very large opportunity cost by tying up funds in securities that could otherwise be used for additional lending in the community. This situation varies by state. The ABA will continue to work on suggestions for addressing collateral requirements.

A number of bankers advocate a hundred percent insurance on municipal deposits, or at least on local municipal deposits. The ABA recognizes that 100 percent raises significant economic and political concerns due to "moral hazard" questions and the political resistance to such an approach. Nevertheless, there is precedent under current deposit insurance practices for a differentiation between municipal and other deposits. Therefore, we believe consideration should be given to providing additional coverage or perhaps granting banks the option to purchase additional insurance for municipal deposits. Any such additional insurance should be limited to some preset level and some definition of local deposits, and the cost of such additional insurance should fully cover any additional risk to the insurance fund.

Too Big To Fail

The ABA has long opposed the too-big-to-fail doctrine and worked with the Congress and regulators to include the limits on its use contained in FIRREA and FDICIA. Nevertheless, important aspects of this doctrine continue to exist. Deposit insurance reform provides an opportunity to revisit the too-big-to-fail doctrine, and hopefully, eliminate it fully.

Merger of the Funds

In the context of comprehensive reform, a merger of SAIF and BIF would be appropriate.

Risk-Based Premiums

In the context of comprehensive reform, the ABA is willing to work with the FDIC to develop an enhanced risk-based structure. However, we want to ensure that the new structure does not result in additional subjectivity or increased premium costs to the industry. Moreover, we oppose any change in the risk-based system that does not link the system to a cap and rebate/dividend plan.

Finally, we want to emphasize that we cannot support, and would oppose, any new approach that results in material additional premium costs to those banks which are currently paying no premiums and which grow at normal rates. The example used by the FDIC in its report would, for example, result in unacceptable material premium increases for many banks. We see no justification for such increases when the insurance funds are above the required reserve ratio.

Smoothing Out Premiums

The FDIC is recommending that the "hard" 1.25 percent designated reserve ratio trigger be softened so that the industry would not be charged very high premiums all at once if the fund falls significantly below the 1.25 percent level. The ABA believes there is merit to smoothing premiums as long as it does not result in additional net premium payments over the long run.

We are troubled by the suggestion in the FDIC's proposal that a band around the 1.25 DRR be established under which no rebate (if over-funded) or surcharge (if under-funded) would be provided. The FDIC would still charge regular premiums within this band. If the goal is always to return to the DRR level, then there should be no band around that level. Since the majority of the time there are few failures and losses, the fund will generally be above the upper level of the band. In effect, this would set a new *de facto* reserve level and would ignore the billions of dollars in lost lending opportunities of over-funding the FDIC.

Moreover, since it is more likely that the fund would be over- rather than under-capitalized, it may be appropriate to consider an asymmetric approach. We suggest a system that would have a more aggressive rebate provision (returning excess funding more quickly) and a less aggressive surcharge provision (thus rebuilding the fund at a slower pace). This kind of asymmetric approach recognizes the opportunity cost of excess funding and the negative impact on lending and the economy that high premiums can have under periods of economic stress.

Independent FDIC Board

Consideration should be given to changing the FDIC Board to make sure it is truly independent, as it is designated to be. The most direct way to do that would be to have three independent board members. Since the board was expanded to five members in FIRREA, more often than not, there have been vacancies on the board. The vacancies tend to be the "outside" seats because the seats held by the Comptroller of the Currency and the head of the Office of Thrift Supervision are always filled (either by the comptroller or the head of OTS or acting directors of those organizations). Thus the Administration has generally had half of the Directors. Such an imbalance threatens the independence of the FDIC and could politicize decisions. Returning to a three-member independent board – which served the FDIC for well over 50 years – should be considered as part of a comprehensive approach to reform.

Conclusion

Mr. Chairman, we are prepared to work with you and the members of this subcommittee to find the best solution to these critical issues. We think this is an excellent time to begin that process – with the industry and the FDIC in excellent health. We sense there is a growing consensus on issues to be addressed and approaches to these issues. We look forward to working with you to see if we can develop legislation to make the FDIC insurance system even stronger.

Appendix A

Capping the insurance fund and providing rebates will not limit the FDIC's ability to meet any contingency. The FDIC has great flexibility to manage the funds to maximize effectiveness, and there are many existing laws that help protect the funds. For example, consider:

Reserves for Future Losses: FDIC has great flexibility to adjust reserves for future losses. This reserve fund is **subtracted** from the fund balance when calculating whether the fund is fully capitalized – i.e., if the fund balance is at least 1.25 percent of insured deposits. Obviously, the larger the reserve for future losses, the smaller the fund balance. Once the fund balance falls below 1.25 percent of insured deposits, premiums must be charged by the FDIC to fully capitalize the fund. Thus, if FDIC anticipates greater potential losses, it can merely set aside reserves, potentially creating a situation where banks would have to pay premiums to maintain the capitalization level of the fund. The FDIC has suggested that this "hard" target of 1.25 percent be "softened" allowing a slower recapitalization than possible under current law. It is important to note that even with such a change, the FDIC still would be able to set aside reserves for future losses, thereby affecting the level of the fund relative to the 1.25 percent level.

Authority to Raise the Designated Reserve Ratio (DRR): The FDIC has the authority to raise the DRR if it can document that it is justified for that year "by circumstances raising a significant risk of substantial future losses to the fund." By raising the DRR, the FDIC would likely be raising the assessments necessary to maintain that new higher level. Thus, if the FDIC foresees problems, it has this additional authority to easily deal with the situation.

Risk-Based Premiums: Risk-based premiums were authorized in 1991 by Congress and implemented in 1993. Several important points should be made: First, the risk-based system provides an automatic self-correcting mechanism. If industry conditions deteriorate and banks' capital falls or supervisory concerns arise, a higher risk-premium is charged and more income is received in the fund. The FDIC has been critical of the fact that nearly 92 percent of the industry falls in the top-rated category and therefore pays no premiums. On the contrary, the incentives are such that nearly all banks want to be in this top category, and given the economic performance of the economy and the banking industry over the last decade, it's no wonder that such a high percentage enjoys the benefits of such a rating.

Second, the FDIC has made additional changes to the risk-based system designed to identify patterns that signal future problems for individual banks. This should serve to improve the sensitivity of the risk-based system to changes, and build in the automatic adjustments sooner than would otherwise have been the case.

Mandatory Recapitalization: If the reserve ratio falls below the DRR, the banking industry must immediately rebuild the fund back to the DRR. If the rebuilding is expected to take longer than one year, a mandatory recapitalization plan at very high assessment rates (minimum 23 basis points of domestic deposits) must be established. Thus, if the industry continues to grow, the practical impact is that the fund balance will never fall below 1.25 percent of insured deposits for any length of time. ***In dollar terms, the fund would therefore always be over $35 billion***. We agree with the FDIC that in times of stress, high premiums that would be required to maintain the DRR may be counterproductive. Moreover, a "hard" 1.25 percent level means that the benefits of such a large fund cushioning the shock of bank failure losses is lost. While maintaining a level of capitalization is important to preserving depositor confidence, proposals that would require a slower re-building would be beneficial to maintaining credit availability during difficult economic times. Again, it is worth noting that the reserves of future losses, mentioned above, provide a cushioning effect and should mitigate large upward swings in premiums.

Additional Authorities that Protect FDIC

Beyond the flexibility to adjust the deposit insurance funds to meet any contingency, there are other important laws and regulations that have fundamentally changed the operating environment for FDIC. ***Taken together, these provisions lower the probability of banks failing and reduce the cost to the FDIC from those that do fail.***

- ***Prompt corrective action:*** This established mandatory regulatory actions as capital levels fall below the minimum requirements.

- ***Critically Undercapitalized institutions:*** This requires mandatory conservatorship or receivership of institutions with capital less than 2 percent. Theoretically, if receivership takes place, the FDIC should suffer no losses on the institution at all.

- ***Holding Company Guarantees/Cross Guarantees:*** This requires the holding company to guarantee compliance with recapitalization plans of the bank and puts losses on sister banking institutions of a holding company in the event that one bank subsidiary fails. By expanding the obligation to cover losses, the FDIC effectively reduces its loss exposure.

- ***Depositor Preference:*** This law elevates the FDIC's claim above general creditors (standing in place of the insured depositors that it has made whole) in the receivership of any failed bank. This superior claimant position will certainly lower resolution costs to the FDIC.

- ***Rules Restricting Too-Big-To-Fail:*** FDIC may not take any action, directly or indirectly, that causes a loss to the insurance fund by protecting depositors for more than the insured portion of deposits or by protecting creditors other than depositors.[4]

- ***Emergency Special Assessment Authority:*** This authority requires the industry to repay any borrowing by FDIC and for any other purpose deemed necessary.

- ***"Least-Cost Rule":*** This requires the FDIC to resolve failures in the least costly manner of all alternatives.

[4] There is a "systemic risk" exception to advance funds if needed to prevent a severe economic effect (upon a determination by the Secretary of the Treasury, in consultation with the President and written recommendation from the FDIC and the Fed). Any costs would be an obligation of the banking industry on a broader base of assets minus tangible capital and sub debt. Also, the Federal Reserve is restricted from providing discount window lending to "undercapitalized" institutions or those with CAMEL 5 ratings. This has the effect of preventing delays that would allow large, uninsured deposits to run before the bank was closed. This provision also extends discount window lending to other nonbank firms for emergencies.

- ***Line of Credit Expanded:*** The 1989 law increased the FDIC's line of credit to the Treasury from $5 billion to $30 billion and made it mandatory for the industry to repay any borrowing.

Simply put, limits on the size of the insurance fund and expanding the rebate authority poses no concern to the FDIC funds – existing laws and regulations provide the needed flexibility to meet any financial obligation that may arise.